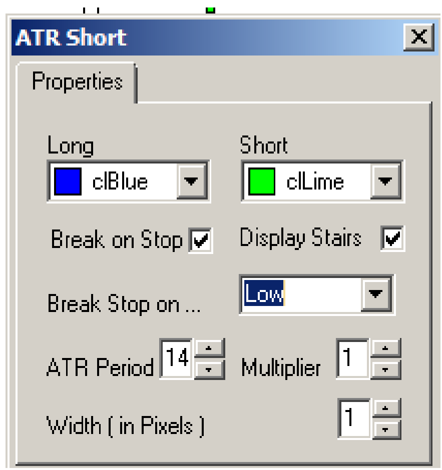
TRADING WITH ATR

By Daryl Guppy

Volatility is the new challenge in modern markets. It has made identifying the end of downtrends and the start or new uptrend more difficult. We have made increased uses of the trader's application of the Average True Range (ATR). The ATR calculation contains a number of variables and in these notes we show how they are selected and combined to give optimal outcomes for individual stocks.

The ATR tool in the GTE charting package is exceptionally useful because it allows the trader to start the ATR calculation from a user selected point selected with the click of a mouse. This is not easily possible with MetaStock where the user must use separate dialog boxes to input the starting point. The calculation parameters for the ATR indicator tool in GTE are shown below.



We start with the basics of the combination use of traders ATR. A short side ATR calculation is applied to a falling trend. The trend reversal is signalled when prices close above the value of the short side ATR. Aggressive traders will use this as an entry point. Conservative traders wait until the value of the long side ATR is higher than the last value of the short side ATR.

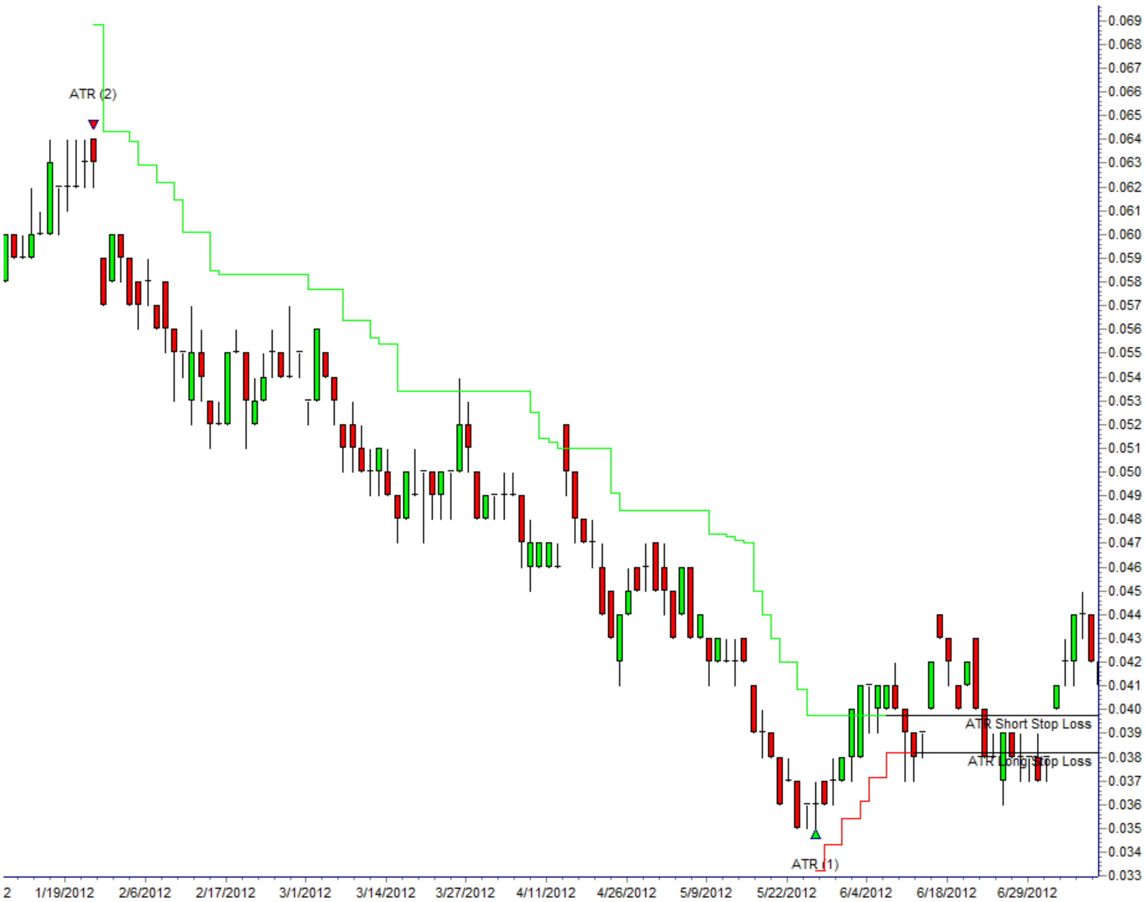
Once the downtrend has ended, a new long sides ATR calculation is applied. When the long side ATR moves above the value of the short side ATR then a long side entry is confirmed. The value of the long side ATR is used as the trailing stop loss. A close below this level is taken as an exit signal.

Under perfect conditions, this is what it looks like on a chart.

Although we may take an aggressive or a conservative entry, when it comes to the exit there is no such distinction. The exit is always taken on the day following the close below the long side ATR.

Usually I am looking for a long side trade, so my assessment of the indicator and its signals start with the short sides ATR. I am looking for two features.

1) Compatibility with the short side ATR as a means of defining the trend. This means there are no false exit signals as the downtrend develops. The chart extract shows the short side ATR is compatible with defining the downtrend. It means that where there is a close above the value of the short side ATR that this has a high probability of signalling a genuine change in the trend. This is shown in the chart.



2) Compatibility with the long side ATR. This means that the trend breakout identified with the short side ATR can also be managed effectively with the long side ATR. The chart shows that this has failed. Prices dip below the value of the long side ATR signalling an exit from any long position. The long side ATR is not suitable for trading the new rising trend because of these exit signals. As the trend develops it may show that these are false exit signals. No matter, it still means the long side ATR is not a suitable trade management tool.

We look for past compatibility with ATR management, and continuing compatibility in the emerging trend. This sets up the broad parameters for ATR trading.

We fine tune ATR trading by adjusting the calculation value of the ATR to better match the volatility of the market. The initial chart extract shows ATR (2) for the short side ATR and ATR (1) for the long side ATR. Why do we select these values and what do they mean?

The ATR calculation provides a value for the average true range over a selected period. Our preference is to use a 14 day moving average period. If this calculation is used then this is an ATR (1) calculation or 1*ATR. This is the most sensitive calculation. It can generate many false exit signals in a trend, but it provides a tighter stop loss.

An ATR(2) calculation takes the ATR(1) calculation value and doubles it. This is also written as 2*ATR.

Next week we look at how change in sensitivity impact on the ATR.

INDICATOR REVISION

TRADERS ATR

The trader's application of the Average True Range (ATR) captures price volatility, defines the emerging trend breakout and provides a method to manage the developing trade. Our purpose is to use the ATR calculation as a stop loss designed to protect capital and identify the end of one trend and the beginning of another. We use the ATR as a method to identify and confirm trend changes. Later we want to use the ATR as a protect profit stop designed to protect profits and identify the end of a trend. Traders ATR is a tool in Guppy Traders Essentials charting.